

Taxation - Contest Prizes Held Taxable

DePaul College of Law

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disturbed, and that this was public policy, as indeed, other courts have done.³³

Of course, if one holds that it is against public policy to allow parol gifts causa mortis to be established on the sole, uncorroborated testimony of the donee, the *Collinson* case may be decided on that one fact, making further discussion academic. However, if the conclusion is that such gifts may be so established, it follows that the alleged donee may testify in his own behalf, although in some jurisdictions, statutes prohibit such testimony. As pointed out by Emmert, J. in a vigorous dissent,³⁴ the modern tendency has not been to extend the class of incompetent witnesses beyond the clear provisions of the statutes.³⁵

Further, the dissent argued, that if the alleged donee may testify, and that testimony is unimpeached and uncontradicted in any material matter, and every circumstance and reasonable inference both from her conduct and testimony corroborated her evidence as to the gift, a trial court, as a matter of law, may not disregard it.³⁶

Thus, we are led to the crux of the conflict. It is a conflict that transcends the law of gifts causa mortis, and may fairly be said to be one of the continuing, and most perplexing problems of our legal system: how far should a court go in varying the common law which derived great force from custom in regard to observance?

Since our legal system permits the legislative will of the people to be manifest, it would seem that courts ought to be chary of inferring that a change in one facet of the previous law by legislative enactment, gives sanction to a court to change another via judicial fiat.

TAXATION—CONTEST PRIZES HELD TAXABLE

A philanthropist established a contest in 1945 wherein he offered \$25,000 for the best symphony written by an American composer. The winning symphony was to remain the property of the composer subject to certain conditions.¹ The appellant, hereinafter referred to as the taxpayer, a musician, composer, and college professor by profession, had composed a symphony during the years 1937, 1938, and 1939.

³³ *McKeon v. Van Slyck*, 233 N.Y. 392, 119 N.E. 851 (1918). The court concluded that corroboration is not essential as a matter of law and it is error to instruct the jury otherwise.

³⁴ *In re Collinson's Estate*, 108 N.E. 2d 700 (Ind., 1952).

³⁵ 2 Wigmore, Evidence, §§ 578, 578a (3rd ed., 1940).

³⁶ *In re Collinson's Estate*, 108 N.E. 2d 700, 707 (Ind., 1952).

¹ The conditions were in part that the Detroit Orchestra, Inc., a nonprofit organization, shall have all synchronization rights as to motion pictures and all mechanical rights as to phonograph recordings, electric transcriptions, and music rolls; exclusive right to authorize the first performance of the composition; right to designate the publisher; right to give a broadcast performance within one year.

It was then placed aside until he entered it in this contest during the year 1946. He was awarded the prize in 1947. Taxpayer claimed benefit of Sec. 107 (b) of the Internal Revenue Code² and computed his tax for the current year, 1947, as though the \$25,000 had been received ratably during the years 1937, 1938, and 1939. Subsequently he filed for refund on the theory that this prize constituted a gift under Sec. 22 (b) (3), Internal Revenue Code,³ and was not taxable. The Commissioner assessed a deficiency, contending this to be taxable income⁴ and placed the income as though it had been ratably received over the 36-month period ending 1947.⁵ The District Court held that the cash prize qualified as a gift under Internal Revenue Code, Sec. 22 (b) (3)⁶ and should not be taxable in the year 1947 or any other year.⁷ The Court of Appeals overruled the lower court in holding for the Commissioner on both points.⁸ The Supreme Court of the United States granted certiorari because of a conflict with a previous decision⁹ and upheld the Circuit Court's findings. *Robertson v. United States*, 72 S. Ct. 994 (1952).

The taxpayer contended and the District Court¹⁰ found that the in-

² Int. Rev. Code § 107 (b), 26 U.S.C.A. § 107 (b) (1949). "For the purposes of this subsection, the term 'artistic work or invention,' . . . means a literary, musical, or artistic composition . . . or a patent or copyright covering an invention of or a literary, musical, or artistic composition. . . . If, in the taxable year, the gross income of any individual from a particular artistic work or invention by him is not less than 80 *per centum* of the gross income in respect of such artistic work or invention in the taxable year plus the gross income therefrom in previous taxable years and the twelve months immediately succeeding the close of the taxable year, the tax attributable to the part of such gross income of the taxable year which is not taxable as a gain from the sale or exchange of a capital asset held for more than 6 months shall not be greater than the aggregate of the taxes attributable to such part had it been received ratably over that part of the period preceding the close of the taxable year but not more than 36 calendar months."

³ Int. Rev. Code § 22 (b), 26 U.S.C.A. § 22 (b) (1949). "The following items shall not be included in gross income and shall be exempt from taxation under this chapter: . . . (3) Gifts, bequests, devises, and inheritances."

⁴ Int. Rev. Code § 22 (a), 26 U.S.C.A. § 22 (a) (1949). "General definitions. Gross income includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . ."

⁵ Int. Rev. Code § 107 (b), 26 U.S.C.A. § 107 (b) (1949); note 2 *supra*.

⁶ Int. Rev. Code § 22 (b) (3), 26 U.S.C.A. § 22 (b) (3) (1949).

⁷ *Robertson v. U.S.*, 93 F. Supp. 660 (D.C. Utah, 1950).

⁸ *U.S. v. Robertson*, 190 F. 2d 680 (C.A. 10th, 1951).

⁹ *McDermott v. Commissioner of Internal Revenue*, 150 F. 2d 585 (App. D.C., 1945).

¹⁰ *Robertson v. U.S.*, 93 F. Supp. 660 (D.C. Utah, 1950).

come was a gift, based on the following arguments: the contest was sponsored by a philanthropist for the purpose of furthering music and creating a unity between the Americas; the sponsor derived no profits from the contest; the composer retained ownership of the composition; the taxpayer's purpose in composing the work was comparable to that of a great poet who is inspired to write an immortal poem and thus make an outstanding contribution to the field of music; and under the *McDermott v. Commissioner of Internal Revenue* case¹¹ this prize would constitute a gift.

The Circuit Court disposed of the taxpayer's arguments by finding that the compensation was the result of professional skill and training of the musician and, when he entered the contest, he was offering the results of his skill and training in exchange for a chance to win the prize money.¹² The court stated that the practical test for purposes of determining whether an income is a gift is whether it was received gratuitously and in exchange for nothing.¹³ Here the taxpayer not only gave the results of his skill and training but also gave up certain rights, previously set forth, relating to his composition. Thus something was in fact given in exchange for the prize. The court further stated that the taxability of a prize or award is determined in accordance with the law applicable to the recipient and the fact that the payer has no financial gain from such payment is of no consequence. The recipient received the prize as a result of his labor just as though he had been paid for the use of it. This court found that the taxpayer was entitled to relief under Sec. 107 (b) of the Internal Revenue Code but ruled that this section expressly calls for the proration of the amount received in a taxable year "over that part of the period preceding the close of the taxable years" not to exceed 36 months. Thus the prize was to be prorated over the years 1945, 1946, and 1947 as prescribed by the Commissioner.

The Supreme Court in holding for the Commissioner stated that acceptance by the contestant of an offer tendered by a sponsor of a contest creates an enforceable contract,¹⁴ and payment of a prize to the winning contestant is in legal effect the discharge of a contractual obligation and is not a gift under Sec. 22 (b) (3) of the Internal Revenue

¹¹ 150 F. 2d 585 (App. D.C., 1945).

¹² *U.S. v. Robertson*, 190 F. 2d 680 (C.A. 10th, 1951).

¹³ *Helvering v. American Dental Co.*, 318 U.S. 322 (1943); *Old Colony Trust Co. v. Commissioner of Internal Revenue*, 279 U.S. 716 (1929); *Bausch's Estate v. Commissioner of Internal Revenue*, 186 F. 2d 313 (C.A. 2nd, 1951); *Thomas v. Commissioner of Internal Revenue*, 135 F. 2d 378 (C.A. 5th, 1943); *Sportswear Hosiery Mills v. Commissioner of Internal Revenue*, 129 F. 2d 376 (C.A. 3rd, 1942); *Willkie v. Commissioner of Internal Revenue*, 127 F. 2d 953 (C.A. 6th, 1942).

¹⁴ *Brown v. Morrissey and Walker*, 106 N.J.L. 307, 150 Atl. 330 (1930); *Palmer v. Central Board of Education*, 220 Pa. 568, 70 Atl. 433 (1908); *Groves v. Carolene Products Co.*, 324 Ill. App. 102, 57 N.E. 2d 507 (1944); *Rest., Contracts* § 521 (1932).

Code.¹⁵ The court further stated that payment of money to the taxpayer in return for services rendered cannot escape taxation as a gift merely because the donor has received no economic benefit.¹⁶ This court gave Section 107 (b) the same interpretation as the Circuit Court in finding that the 36-month period should end with the current taxable year. It is interesting to note that, even though both the Circuit Court and the Supreme Court arrived at the same conclusion as to the taxability of the prize money to the recipient, the conclusion of each court rests on a different basis. The Circuit Court found that the prize was taxable by way of excluding it from the gift category, whereas the Supreme Court rationalized that there was a contractual obligation here.

The primary question in this case was whether this was a nontaxable gift or not.¹⁷ The Internal Revenue Code broadly defines gross income, and such all-inclusive terms indicate a legislative intent that income should be taxed comprehensively.¹⁸ The Code lists incomes which are to be excluded from gross income, and an income must clearly come within these bounds to be nontaxable.¹⁹ The problem of the taxability of prizes won in contests has been before the courts on previous occasions. Prize winners generally are required to include their prize in their income tax returns. With few exceptions, the Internal Revenue Bureau has consistently held that prizes were includable in the gross income of the recipient on the theory that such awards represented compensation for meeting the conditions of a contest or for aiding in the advertising program of the sponsor.²⁰ The holder of the winning number on a meal ticket was required to pay a tax on the fair market value of an automobile he won.²¹

In holding that awards for scientific achievement and outstanding service, such as the Nobel Prize, were nontaxable where no personal service was rendered and no competitive element was present, the Bureau stated:

It appears that the award was made to the taxpayer in recognition of his achievements in science and his services in promoting the public welfare. An award of this kind made by one to whom no services have been rendered is a gratuity as distinguished from compensation for services. Clearly the award was not a competitive prize. This office is of the opinion, therefore, that the amount received by the taxpayer constituted a gift and is exempt from income tax.²²

¹⁵ *Robertson v. U.S.*, 343 U.S. 711 (1952).

¹⁶ Int. Rev. Code § 22 (b) (3), 26 U.S.C.A. § 22 (b) (3) (1949).

¹⁷ *Ibid.*

¹⁸ Int. Rev. Code § 22 (a), 26 U.S.C.A. § 22 (a) (1949).

¹⁹ Int. Rev. Code § 22 (b) and 116, U.S.C.A. § 22 (b) and 116 (1949).

²⁰ I.T. 1651, June Cum. Bull. 54 (1923).

²¹ I.T. 1667, June Cum. Bull. 54 (1923).

²² G.C.M. 5881, June Cum. Bull. 28 (1929).

The facts of the *Robertson* case differ from the above qualifications in that the award was a competitive prize and was for services rendered.

The Circuit Court in the *Robertson* case cited *Stein v. Commissioner*²³ and stated that where a person enters a contest which offers a valuable award and wins and accepts that award its value is taxable to him because, if his primary motive were to advance an art or a scholarly pursuit, he could refuse to accept the prize. However, the court failed to take note that the Stein decision rested more heavily on the fact that the payer treated the cost of the prize as an ordinary business expense thereby making the prize almost automatically taxable to the recipient. In this case, Pabst Brewery conducted a contest and gave prizes in celebration of an anniversary, which contest was used for business publicity. The company treated the award not as a gift but as an ordinary business expense for the current taxable year. Where the donor does not treat the payments as an expense but charges them directly to surplus as in *Bogardus v. Commissioner*,²⁴ the court must look to the services rendered by the recipient to establish taxability.

The Tax Court has liberalized the rule that prize winners are generally required to report their winnings in their income tax returns, by holding that a "windfall" prize from a commercial radio program was a gift, not includable in gross income in *Washburn v. Commissioner*.²⁵ Here the court pointed out that the winner had employed no capital, contributed no labor, made no wager, gave no endorsement of the sponsor's product, and assumed no obligation when she was awarded and accepted the "Pot O' Gold" money. Further, the donor had designated the payment an "outright cash gift" and the court so found.

A prize of \$3,000.00 awarded by the American Bar Association for the best discussion on an assigned subject, which prize money was derived from the income of a trust fund established for this purpose, was held nontaxable in *McDermott v. Commissioner of Internal Revenue*.²⁶ Here the court found that the purpose of the donor and the trustee, American Bar Association, was to incite scholarly work by the gift, not to employ or buy. The court distinguished between taxable prizes given for commercial purposes and nontaxable awards for outstanding scholarly or humanitarian achievement by stating:

Any services rendered by the recipient were not rendered to the trustee of the fund and the trustee derived no profit as a result of the contest. This distinguishes this prize from puzzles, guessing contests, and publishers' contests operated for commercial purposes.

²³ 14 T.C. 494 (1950).

²⁴ 302 U.S. 34 (1937).

²⁵ 5 T.C. 1333 (1945).

²⁶ 150 F.2d 585 (App. D.C., 1945).

The importance of the donor receiving no economic benefit has been introduced in other cases.²⁷

The Solicitor General did not petition for certiorari on this case; yet, when the *Robertson* case came along several years later with similar facts another circuit court (*McDermott* case was a circuit court decision) criticized the *McDermott* case by stating that the court in the latter case placed too much importance on the donative intent of the nonprofit association and on the nonpecuniary motive of the taxpayer. The Supreme Court effectively overruled the *McDermott* case by stating in the *Robertson* case that where there is a payment for services rendered, it is immaterial whether the donor received an economic benefit from the services.

The remaining question involved in the *Robertson* case concerns the period over which income from a work that takes in excess of 36 months to perform may be allocated for income tax purposes. This is a less trying question as it simply involves an interpretation of Sec. 107 (b) of the Internal Revenue Code. The hardship of taxing a person who received all or nearly all of the income in one year, where he had worked a number of years to earn this income, was first dealt with by Congress in Sec. 220 of the Revenue Act of 1939, Sec. 107 of the Internal Revenue Code. It provided in part that where personal services were rendered by an individual over a period of five years or more from the beginning to completion of the services and he had not received at least 95 per cent of the pay until completion, the taxpayer could allocate the income over the years included in the period. This section was subsequently changed, primarily by the Revenue Act of 1942, reducing the period to 36 months from five years along with other changes.

Sec. 107 (b) of the Internal Revenue Code is an exception under the general rules governing taxation of income, and a taxpayer seeking to avail himself of the benefits of this exception must bring himself clearly within its bounds.²⁸

The taxpayer offered the case of *Williams v. United States*²⁹ as a basis for allocating the 36-month period backwards from date of completion of his composition. The *Williams* case held that where an inventor worked on an invention from 1925 to 1931 and received payment

²⁷ *Helvering v. Amreican Dental Co.*, 318 U.S. 322 (1943), where creditors' gratuitous cancellations of indebtedness without consideration were held to be gifts and not income to debtor; *Amirikian v. U.S.*, 100 F. Supp. 263 (D.C. Md., 1951), which held that where a philanthropic trust, organized for purpose of encouraging and stimulating interest and study in respect to development of arc welding industry, offered a prize for a paper written on the industry, such prize was a gift.

²⁸ *Smaet v. Commissioner of Internal Revenue*, 152 F. 2d 333 (C.A. 2d, 1945); *Lindstrom v. Commissioner of Internal Revenue*, 149 F. 2d 344 (C.A. 9th, 1945).

²⁹ 84 F. Supp. 362 (Ct. Cl., 1949).

for this invention in 1942, he was entitled to compute his taxes as if the sum received in 1942 had been received ratably during the 36-month period ended on February 7, 1931, the date of completion. Both the Circuit Court and the Supreme Court in the *Robertson* case found that the statute expressly calls for proration of the amount received in a taxable year "over that part of the period preceding the close of the taxable year" not to exceed 36 months. Thus the income will be allocated over the 36-month period preceding the close of the taxable year in which received even though the actual work was performed in years preceding the date of payment by more than 36 months.

Thus it appears that in nearly all cases of prizes won in contests the value of the prize will be taxable unless it can be demonstrated that the prize was given as a gift to aid the furtherance of science or education, or the award is made in recognition of past achievements or present abilities,⁸⁰ and not given in exchange for services rendered. One must look to the nature and intent of the donor⁸¹ and also determine whether services were rendered by the recipient. If the donor is a nontaxable philanthropic trust, it is easier to establish the requisite conditions necessary to constitute the prize a gift.

CONTRACTS—COURT OF CLAIMS RULES REVOCATION OF OFFER BEFORE ACCEPTANCE INEFFECTIVE

In response to a government solicitation, the plaintiff submitted a bid (offer) on a contemplated contract. Prior to acceptance by the government, but after the bids had been opened, the plaintiff attempted to revoke this offer. In a very curious opinion the Court of Claims declared that this revocation was ineffective. *Refining Associates Inc. v. United States*, 109 F. Supp. 259 (Ct. Cl., 1953).

In recent years the Court of Claims has made some pronouncements concerning contract law which seem contra to all precedent and reason. This was not so eight years ago, when in the case of *Miller v. United States*,¹ the court handed down a superlative decision presenting an accurate analysis of the common law principles governing offer and acceptance of contracts.

The *Miller* case involved a plaintiff who, after submitting a bid of

⁸⁰ *Old Colony Trust Co. v. Commissioner of Internal Revenue*, 279 U.S. 716 (1929).

⁸¹ *Commissioner of Internal Revenue v. Jacobsen*, 336 U.S. 28 (1949); *Bogardus v. Commissioner of Internal Revenue*, 302 U.S. 34 (1937); *Smith v. Manning*, 189 F. 2d 345 (C.A. 3rd, 1951); *Poorman v. Commissioner of Internal Revenue*, 131 F. 2d 946 (C.A. 9th, 1942); *Fisher v. Commissioner of Internal Revenue*, 59 F. 2d 192 (C.A. 2d, 1932).

¹ 62 F. Supp. 327 (Ct. Cl., 1945).